Maximise Income with a Multi-Asset Strategy

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Against the backdrop of a volatile market, securing reliable income is paramount. However, investors on the hunt for yields shouldn't limit themselves to just traditional coupons and dividends.

In a joint interview Ed Perks, Chief Investment Officer and Todd Brighton, Senior Vice President, Portfolio Manager from Franklin Income Investors share more about the importance of taking a multi-asset approach to income and their outlook ahead.

QUESTION **01**

Whispers of a recession are growing louder. How do you anticipate the potential impact of a recession particularly in light of recent banking failures? And what steps do you take to manage credit risks during economic downturns?

It is our view that the recent bank failures are unique situations (i.e. they are not systemic). However, these events have raised the likelihood that lending to consumers and businesses becomes more constrained. Tighter financial conditions could lead to a further pullback in economic activity. Given the potential for an economic slowdown in 2023, we continue to emphasize diligent security selection focusing on businesses with greater potential for resiliency in an economic downturn.

Merits of a given investment are regularly evaluated by our research analysts, based both on bottom-up fundamental security analysis and a wide range of top-down considerations such as interest rates, inflation, commodity prices, the credit cycle, and other macroeconomic factors. For credit risk specifically, we continually monitor the underlying fundamentals of our fixed income portfolio, both at the issuer and individual holdings level, to ensure that we are being adequately compensated for the relevant risks.

Against the backdrop of a potential recession, we have the flexibility to further shift the allocation towards higher quality fixed income securities such as investment grade corporate bonds and US Treasuries. And while we are currently constructive on high yield, we have the latitude to rotate out of this sector and deploy capital into sectors or businesses that are more resilient in an economic downturn.

QUESTION 02

With inflation on top of minds of investors, how are you navigating this regime shift for the portfolio in an era of higher interest rates?

What happens with interest rates and inflation throughout the rest of 2023 will primarily drive our allocation decisions. We believe the move higher in rates is likely almost done, as markets have begun to price in the end of the Fed's hiking cycle. As the banking crisis in March unfolded, it became clear that the pace and scale of interest rate hikes placed bank balance sheets under considerable stress. As a result, the Fed faces greater uncertainty around its path forward, particularly if the lagged effect of tightening financial conditions and a more challenging growth environment results in a real pullback in fundamentals.

We have already made a significant shift toward fixed income during the past year, driven by profit-taking on equity sectors that outperformed in 2022 – such as pharmaceuticals, consumer staples and utilities. If equity prices remain elevated relative to the yield we can achieve in fixed income, then the shift into bonds may continue, albeit at a slower pace as we are now above a 60/40 allocation in favour of fixed income over equities. The rate of change will depend upon where markets go. If investment-grade corporate bond yields move back toward 6%, then we may well increase the strategy's exposure at a faster pace, taken from either equities, equity-linked notes, high yield bonds or US Treasuries.

QUESTION 03

How do you balance the trade-off between yield and credit risk in your portfolio?

While the Franklin Income Fund ("Target Fund") seeks to generate attractive income, it also aims to provide capital appreciation potential and healthy risk-adjusted returns. We seek to balance the need to generate income with the need to protect capital.

Within corporate bonds, we analyse companies and their potential, seeking to achieve attractive risk -adjusted total returns on a security-by-security basis. The investment criteria we evaluate include valuation, financial strength, and profitability. Based on an assessment of a company's capital structure, we seek to identify those securities with the most attractive risk/reward characteristics. Security selection and asset class allocation are not mutually exclusive; there are instances in which we may own multiple tranches of a company's debt structure and/or equities. Each decision is based on the merits of the individual security.

In addition to our in-depth bottom-up fundamental research, ongoing risk management is another important element in the overall investment process. We partner with a dedicated Risk Manager who monitors the portfolio and consults with us on any potential risk issues. Together we look at risk budgeting and decomposition, and discuss and debate portfolio holdings, positioning relative to the benchmark and analyst ratings, as well as look to identify unintentional or uncompensated risk exposures.

QUESTION 04

What are the fixed income opportunities (e.g. sector, country) do you see for the rest of 2023? Do you favour investment-grade or high-yield?

Investment-grade credit is our preferred asset class in terms of total return, income, and risk management. In a positive economic scenario, we believe these assets can perform quite well as rates move lower and spreads narrow. At the start of 2022, yields on high-quality credit did not seem attractive, as prospects for total returns were poor, and bonds did not have the ability to act as a diversifier with the risk-free rate below 1%. Today, we believe the same assets offer better total return potential than equities with less volatility, while the positive correlation with stocks is also breaking down, allowing fixed income to offset equity market volatility.

While investment-grade corporates is our preferred sector within fixed income, the high-yield bond market may be more resilient than many investors believe, absent a significant negative impact on corporate earnings. Most high-yield issues won't need to be refinanced in the next few years; therefore, a recession in 2023 with a modest pullback doesn't overly concern us. As a result, while the investment community focuses on whether spreads are wide enough to justify a move into credit, we see opportunities at current yields, which have shot up to levels not seen for 15 years. We believe yields are adequately compensating us for the risks at this point, and lower US dollar prices make the opportunity more attractive.

While constructive, we continue to believe in the importance of being selective in high-yield credit, particularly given the prospect of a difficult economic backdrop. Recessionary conditions could put pressure on over-levered companies that need to refinance their debt, but we have the resources to engage with the public companies we are already invested in around refinancing solutions. We are less likely to target private middle-market companies because we believe the opportunities for healthy returns in the public markets are currently very attractive, and we wouldn't be adequately compensated for the illiquidity premium associated with such private investments.

QUESTION
05
Why is it important for investors to take a multi-asset approach to income investing?

We believe that a multi-asset class approach is important to investors for the following reasons:

- ***Larger opportunity set:*** A wide investment universe and flexible approach to portfolio construction allow investing across equities (common and preferred stock), equity-linked securities (convertibles and equity-linked notes) and fixed income securities (corporate bonds, government and government agency securities, and securitized instruments).

- ***Multiple sources of income:*** Dividend paying stocks, coupon paying bonds, and equity-linked notes are some of the securities that the Target Fund regularly invests in. Instead of being constrained only to fixed income, a multi-asset class approach would provide investors access to asset classes such as dividend-paying stocks and equity-linked notes that can pay relatively healthy income even during period of low rates.

- ***Diversification potential:*** A broad exposure to equities and fixed income can help lower volatility. At a broad level, fixed income (high quality, in particular) generally provides safety or downside protection during periods of economic slowdown while equities can provide growth during periods of economic expansion. By having exposure to both asset classes within a single portfolio, investors may be able to lower volatility such that not one asset class dominates performance.

Since the portfolio's inception, we have followed a flexible investment strategy, seeking current income and long-term capital growth by investing in a diversified portfolio of stocks, convertible securities, and bonds. The Target Fund has no set targets on its allocations, as we look opportunistically across asset classes and companies' capital structures to focus on investment opportunities that we believe offer the most compelling risk/reward profiles. We believe this asset class diversification and flexibility are key to building a portfolio that can deliver income as well as compelling total return prospects over the long-term.